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SUBJECT: RUSSIA-CHINA GAS DEAL UNLIKELY TO RESULT IN
SIGNIFICANT DELIVERIES ANYTIME SOON

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Summary

11. (C) A gas "deal" signed during PM Putin's recent trip to China is very unlikely to result in significant gas flows from Russia to China anytime soon. Obstacles to Russian gas deliveries include a lack of transportation infrastructure, a lack of agreement on the price of gas, and a lack of developed fields in East Siberia. Chinese Embassy Econ Counselor Pei Jiansheng told us on October 20 that China would be willing to provide financing for the development and transportation projects needed, but that China currently expects Gazprom to develop facilities using its own means. Gazprom's Foreign Relations Director, Ivan Zolotov, told us on October 21 that sending gas to China is "hugely expensive" and that Gazprom would likely have to accept far lower prices than it receives from European customers. Zolotov and some analysts suggest the first gas to China is likely to be in the form of LNG. If so, we see little immediate significance in the signature deal of Putin's China visit. End summary.

GAS AGREEMENT

12. (C) During PM Putin's recent trip to China, Gazprom and China's CNPC signed a "framework agreement" on future gas sales. The deal is reportedly vague in its terms, but calls for up to 70 billion cubic meters (bcm) of gas from Russia to China, with first deliveries beginning in 2014. Chinese Embassy Economic Counselor Pei Jiansheng told us on October 20 the agreement only provides "general parameters" for a future deal and that details would be negotiated in the future. Pei indicated that two pipelines, yet to be built, would supply gas from East and West Siberia, and confirmed a target date for first gas sales "before 2015."

"HUGELY EXPENSIVE"

13. (C) Gazprom's Foreign Relations Director, Ivan Zolotov, told us on October 21 that specialists were still "working out details" of a future deal and that the two sides only agreed "to keep looking at the prospect of selling gas to China." He said it was unclear when gas would be sold by pipeline, since the projected pipelines are "hugely expensive." He estimated that building the pipelines would cost \$12 billion. Zolotov then blurted out "We're not going to spend that kind of money just to satisfy political imperatives." After noting that he "probably shouldn't have said that," Zolotov added that Gazprom "would not sink the company to please politicians."

14. (C) Zolotov explained that East Siberian gas contains much more sulfur than West Siberian gas, and thus needs very expensive additional refining before sale. Therefore, he noted, gas from East Siberia costs substantially more to produce.

15. (C) Analysts speculate that China could finance the pipelines and processing facilities, as well as field development. This was the model of a recent deal related to Russian oil sales to China (ref C). Pei told us China currently expects Gazprom to develop the gas and related infrastructure using its own resources, but added that China could offer financing, if needed. Tatiana Mitrova (protect), head of the Center for International Energy Markets Studies at the Russian Academy of Sciences, told us recently that

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Chinese loans would be needed to meet the "really optimistic" timeline set out in the deal.

PRICE

16. (C) Many analysts have emphasized that price remains the key sticking point on a final deal between China and Russia on gas. Gazprom reportedly wants prices closer to what it charges European customers, while China reportedly wants prices closer to its domestic alternative, cheap coal. Zolotov admitted that Gazprom expects to receive much lower prices from China than it does for the gas it sells to Europe. He said Gazprom "is not happy with Asian prices," but that it would "have to adjust" to them. First Deputy Foreign Minister Andrey Denisov told Ambassador Richard Morningstar, visiting Special Envoy for Eurasian Energy (ref A), on October 12 that China has been "very insistent on a coal-price link." Chinese Econ Counselor Pei said the deal stipulates that a future agreement would contain a price formula linked to the "Asian Oil Basket" and the European gas price. (Note: It is impossible to know what such links mean for a final price, as any other variable could be used to modify these links -- e.g. "the price shall be half the European gas price." End note.)

SOURCE OF GAS UNCLEAR

17. (C) The lack of developed gas fields in East Siberia is yet another complication hindering future gas sales to China. In addition to processing costs, Gazprom would need to spend billions of dollars to develop the large available resource base in East Siberia. Gazprom's acquisition from TNK-BP of the prized field in the region, Kovykta, is still pending. Currently, Russia produces significant volumes of gas in the east only in the Sakhalin region, and it largely sells this gas as LNG from the Sakhalin II project. Zolotov indicated that Sakhalin II LNG would likely be the first source from which Gazprom would sell gas to China. Alfa Bank chief strategist Ron Smith (protect), agreed. While bullish on the

deal and its significance for Gazprom "in the long term," he admitted that "first cargoes will be LNG, likely at spot prices." One possible source of gas for China is the ExxonMobil-led Sakhalin I project, which would like to sell approximately 8 bcm of gas. However, the Sakhalin I consortium has yet to reach agreement with Gazprom on selling its gas, with price being the sticking point.

COMMENT

¶8. (C) Large volumes of new gas from East Siberia are unlikely to be available for at least a decade, while building pipelines from West Siberia to eastern China will be very expensive. Identifying sources of capital to develop new fields and construct pipelines will be difficult as Gazprom faces its own severe financial pressures (ref D). For its part, China currently relies on domestic coal, and has ready access to the global LNG market, which is offering low prices that are forecast to continue due to the global gas glut (ref B). All these factors make it unlikely that Russia will send China significant volumes of gas anytime near the 2014 target date envisioned in the deal announced during Putin's China trip. That said, Chinese determination and willingness to finance could accelerate the process. Absent a strong dose of those two forces, however, China likely will only be able to buy gas from Russia in small volumes as LNG on the spot market for the next several years.

The positive attention given the gas deal in the Russian media appears to reflect more on Gazprom's current difficult economic situation than it does on the real prospect of near-term Russian gas sales to China.

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